

Part III – Administrative, Procedural, and Miscellaneous

Executive Stock Options Settlement Initiative

Announcement 2005-19

Section 1. Purpose of the Initiative

The Internal Revenue Service announces an initiative to resolve transactions that are the same as or substantially similar to those described in Notice 2003-47, 2003-2 C.B. 132. Taxpayers have until May 23, 2005, to notify the Service of their intent to participate in this settlement initiative.

The Service identified this transaction as a listed transaction in Notice 2003-47 and believes it will prevail in litigation both on the merits and in imposing penalties. The Service has decided, however, that for efficient tax administration reasons it will offer affected parties an opportunity to resolve quickly their tax issues and avoid protracted and costly litigation through the execution of a closing agreement pursuant to this announcement.

Section 2. The Parties and Eligibility Requirements

A typical Notice 2003-47 transaction (Transaction) involves an officer, director or employee (Executive) to whom a compensatory non-statutory stock option or restricted stock¹ is granted in connection with the performance of services for a corporation (Corporation). The Executive transfers the stock option to an entity (Related Person), which is typically a limited partnership substantially owned by the Executive and immediate family members. The Related Person typically pays for the stock option by giving the Executive a deferred payment obligation such as a long-term, unsecured note with principal payments deferred until maturity, or an annuity.

¹ The term “restricted stock” refers to a grant to an Executive of stock that is not substantially vested at the time of grant, as defined in Treas. Reg. § 1.83-3(b). Unless otherwise noted, references to stock options also include restricted stock.

This initiative is open to (1) the Executive and the Related Person and (2) the Corporation, if:

- (a) The Executive transferred the option to the Related Person before July 2, 2003; and
- (b) The person electing to participate is not a party in a court proceeding to determine the tax treatment of the Transaction.²

The Corporation may participate in this settlement initiative without the Executive or Related Party and the Executive may participate without the Corporation. However, the Executive must participate with the Related Person.³

Section 3. Settlement Terms for Participating Parties

- (a) **For the Executive and the Related Person**, except as provided in Section 3(c)(1), the terms of the closing agreement entered into pursuant to this announcement must include the following --

- (1) **Compensation Income.** The Executive must recognize total compensation income equal to the fair market value of the stock covered by the stock option measured at the exercise date (or vesting date for restricted stock), less any amounts paid for (i) the stock on exercise of the option (the exercise price) by the Related Person, and (ii) the option by the Executive. The Executive must recognize the compensation income in the taxable year that the Related Person disposed of the stock or, if not yet disposed of, in the taxable year that includes December 31, 2004. However, if in an earlier taxable year the Executive received payments on the deferred payment obligation, or received payments of cash or property other than a deferred payment obligation as consideration for the option, the Executive must recognize the payments (other than amounts recognized under Sections 3(a)(3) and 3(a)(4)), as compensation in the taxable year(s) the payments are received.
- (2) **Gain Recognition.** The Executive must recognize gain if the amount paid by the Related Person for the option (that is, the amount of the deferred payment

² For an electing Executive, neither the Executive nor the Related Person may be a party to such a court proceeding. This exception also applies to a person who is a party to a court proceeding in that person's capacity as partner in an entity subject to the unified partnership audit and litigation provisions of §§ 6221 through 6234, as enacted by the Tax Equity and Fiscal Responsibility Act of 1982.

³ If the Related Person is a pass-through entity, all members of the pass-through entity must agree to participate in the settlement initiative.

obligation⁴ and any cash or property other than a deferred payment obligation) exceeds the amount recognized as compensation income under Section 3(a)(1). Gain not yet recognized and attributable to (i) the deferred payment obligation that would be recognized on receipt of the deferred payment obligation under the relevant provisions of the Internal Revenue Code and Income Tax Regulations and (ii) cash or property other than a deferred payment obligation, must be recognized in the taxable year that the Related Person disposed of the stock or, if not yet disposed of, in the taxable year that includes December 31, 2004. The Executive may not recognize any loss.

- (3) **Interest on Deferred Payments.** The Executive must recognize interest income on the deferred payment obligation when the interest is paid or accrued, whichever is applicable under the relevant provisions of the Code and regulations for interest (for example, § 1272). The Related Person may be entitled to an interest expense deduction as determined under § 163 and other applicable Code provisions.
- (4) **Annuities.** Section 72 governs annuity payments received by the Executive. For purposes of calculating the excludable amount, the amount of compensation determined under Section 3(a)(1), plus any gain attributable to the annuity that has been recognized by the Executive at the time the closing agreement is executed, is treated as the investment in the contract. The portion of each annuity payment not excluded must be included in the Executive's income.
- (5) **Transaction Costs.** The Service will not challenge the capitalization, deduction, or amortization of costs paid by the Executive or Related Person to investigate, pursue, and, consummate the Transaction, including promoter fees and fees for accounting, appraisal, and legal services (Transaction Costs). To the extent the Executive or Related Person that paid those costs has not claimed a deduction on a previously filed U.S. federal income tax return for those Transaction Costs, that person may claim the deduction in the taxable year that includes the taxable year in which the Executive recognizes the compensation income under Section 3(a)(1).
- (6) **Federal Insurance Contributions Act (FICA) Tax.** The Executive must pay the employee's share of FICA tax on the compensation income recognized

⁴ For example, if the deferred payment obligation is a note, the amount of the note would be the stated principal amount of the note received if the note provides for interest at a rate at least equal to the applicable Federal rate. For purposes of this initiative, the amount of an annuity is the present value of the annuity determined on the transfer date using the same actuarial assumptions and interest rate used to formulate the annuity if such assumptions were reasonable; otherwise the valuation must be determined using reasonable actuarial assumptions and interest rate.

under Section 3(a)(1) in accordance with the timing rules under Section 3(a)(1).

- (7) **Penalty.** The Executive must pay an accuracy related penalty under § 6662 equal to ten percent of the amount of any underpayment (as defined in § 1.6664-2(a) of the Income Tax Regulations) attributable to the Transaction unless the Executive filed a valid disclosure under Announcement 2002-2, 2002-1 C.B. 304. For the taxable year that includes December 31, 2004, the amount of the underpayment attributable to the Transaction is equal to the increased tax resulting from the income recognized under Sections 3(a)(1) and (2) (as applicable) in that taxable year. An Executive that filed a qualified amended return is eligible to participate in this settlement initiative.
- (8) **Related Person's Stock Basis.** The Related Person's basis in the stock is equal to the sum of (i) the income and gain recognized under Sections 3(a)(1) and (2), (ii) the exercise price paid for the stock, and (iii) the amount, if any, paid for the option or restricted stock by the Executive. The acquisition date is deemed to be the date on which the option was exercised.
- (b) **For the Corporation,** except as provided in Section 3(c)(2), the terms of the closing agreement entered into pursuant to this announcement must include the following --

 - (1) **Compensation Deduction.** The Corporation may claim a compensation deduction no greater than the total compensation determined under Section 3(a)(1). To the extent the corporation has not already claimed the compensation deduction, it may claim the deduction in a taxable year that includes any of the following: (i) the date the Executive transferred the stock option to the Related Person; (ii) the date the option was exercised (or the stock vested); (iii) December 31 of the year in which the Executive recognized the compensation; or (iv) December 31, 2004.
 - (2) **FICA Tax.** The Corporation must pay the employer's share of FICA tax on the compensation income determined under Section 3(a)(1) for the calendar year ending during the taxable year in which the Corporation claims the deduction under Section 3(b)(1). In addition, for the same taxable year, the Corporation must pay the employee's share of FICA tax for each Executive that participated in a Transaction but does not settle under this settlement initiative (Non-participating Executive). The payment of both the employer's and employee's shares of FICA tax is made without interest. In addition, the Corporation must issue a Form W-2c, Corrected Wage and Tax Statement, as specified in the closing agreement.
 - (3) **Transaction Costs.** The Service will not challenge the capitalization, deduction, or amortization of Transaction Costs paid by the Corporation to investigate, pursue, and consummate the Transaction. To the extent the

Corporation has not claimed a deduction on a previously filed U.S. federal income tax return for those Transaction Costs paid by the Corporation, it may claim the deduction in the same taxable year in which the compensation deduction is claimed under Section 3(b)(1).

- (4) Penalties.** No penalties will be imposed on the Corporation for its participation in the Transaction.
 - (5) Withholding for Supplemental Wages.** If the Corporation participates in this settlement initiative and one or more of its Executives do not, then for each Non-participating Executive, the Corporation must satisfy its withholding liability by paying an amount equal to the applicable flat supplemental withholding rate times the Executive's compensation income as determined under Section 3(a)(1) for the taxable year in which the Corporation claims the deduction under Section 3(b)(1). The payment is made without interest; however, the Corporation must issue a Form W-2c as specified in the closing agreement.
- (c) Special Terms Where Option Not Exercised.** If the stock option has not been exercised or the restricted stock has not vested by February 22, 2005, the terms of the closing agreement entered into pursuant to this announcement must include the following --

(1) For the Executive and Related Person--

- (i)** In the year the option is exercised or the restricted stock vests, the Executive must recognize total compensation income as determined under Section 3(a)(1). Gain must be recognized in accordance with Section 3(a)(2), except that the taxable year the option is exercised or the restricted stock vests is substituted for the taxable year that the Related Person disposed of the stock or, if not yet disposed of, the taxable year that includes December 31, 2004. Interest on the deferred payment obligation must be included in income as described in Section 3(a)(3). Annuity payments must be included in income as described in Section 3(a)(4). All other payments made on the deferred payment obligation before exercise (or vesting) must be recognized as compensation income in the years in which the payments are received. If the Executive received cash or property other than the deferred payment obligation before February 22, 2005, the Executive must recognize compensation income in the year received.
- (ii)** The Executive must pay the employee's share of FICA tax on the compensation determined under Section 3(a)(1) in the same taxable year(s) the compensation income is recognized under Section 3(c)(1)(i).

- (iii) The Executive or Related Person may deduct the Transaction Costs paid by the Executive or Related Person (as appropriate) but only in the year the Executive recognizes income under Section 3(c)(1)(i) and only to the extent of compensation income recognized by the Executive up to and including that year. The Executive or the Related Person (as appropriate) must include in income for the taxable year that includes December 31, 2004, any Transaction Costs deducted or amortized in years before February 22, 2005, including amounts claimed in a year barred by the period of limitations on assessments.
- (iv) Unless the Executive filed a valid disclosure under Announcement 2002-2, the Executive must pay an accuracy-related penalty of ten percent on the underpayment attributable to the Transaction in the taxable year(s) determined under Section 3(c)(1)(i). For the taxable year(s) determined under Section 3(c)(1)(i), the amount of the underpayment attributable to the Transaction is equal to the increased tax resulting from the income recognized under Sections 3(a)(1) and (2).
- (v) The Related Person is entitled to basis in the stock (or the option before exercise) equal to the sum of (i) the income and gain recognized under Sections 3(a)(1) and (2), (ii) the exercise price paid for the stock when the option is exercised, and (iii) the amount, if any paid, for the option or restricted stock by the Executive.

(2) For the Corporation--

- (i) The Corporation may claim a deduction for the compensation income as determined under Section 3(a)(1) for the taxable year that includes the taxable year(s) in which the Executive would recognize the compensation income under Section 3(c)(1)(i).
- (ii) The Corporation may deduct the Transaction Costs paid by the Corporation as described in Section 3(b)(3) in the taxable year the Corporation claims the compensation deduction under Section 3(c)(2)(i).
- (iii) The Corporation must pay the employer's share of FICA tax on the compensation income determined under Section 3(a)(1) for the calendar year ending during the taxable year in which the Corporation claims the compensation deduction under Section 3(c)(2)(i). In addition, for the same taxable year, the Corporation must pay the employee's share of the FICA tax for each Non-participating Executive.
- (iv) If the Corporation participates in this settlement initiative and one or more of its Executives do not, then for each Non-participating Executive, the Corporation must satisfy its income tax withholding liability by paying an amount equal to the applicable flat supplemental withholding rate

(including the mandatory 35 percent rate for supplemental wages in excess of \$1,000,000) times the Executive's compensation income as determined under Section 3(a)(1) for the taxable year in which the Corporation claims the deduction under Section 3(c)(2)(i).

- (d) Corporation Must Participate for All of its Executives.** The closing agreement must apply with respect to all of the officers, directors, and employees of the Corporation that participated in the Transaction with respect to which there was a transfer of the stock option before July 2, 2003.
- (e) Estate and Gift Taxes.** Execution of a closing agreement under this settlement initiative does not affect the application of gift, estate and generation-skipping transfer taxes which may result from the Transactions covered by this settlement initiative.
- (f) Related Person.** Execution of a closing agreement under this settlement initiative does not preclude the Service from pursuing with the Executive or the Related Person (and its members) additional adjustments related to the activities of the Related Person (other than as specified in Section 3(a)(8)).
- (g) Other Matters.** Execution of a closing agreement under this settlement initiative does not preclude the Service from investigating any associated criminal conduct or recommending prosecution for violation of any criminal statute.

Section 4. Procedures for Closing Cases

(a) Notice of Election. To notify the Service of their intent to participate in this settlement initiative, persons must send the Notice of Election (Form 13656 for Executives and Related Persons and Form 13657 for Corporations) on or before May 23, 2005. The Service will not extend the time period for submitting the Notice of Election. If the Related Person is a pass-through entity, each member of the entity must sign the election.

The Notice of Election should be sent by certified mail or designated delivery service (within the meaning of § 7502(f)) and must be sent to:

INTERNAL REVENUE SERVICE
Attn: Announcement 2005-19
MC 4166 NWSAT
4050 Alpha Rd
Farmers Branch, TX 75244

Persons under examination or in Appeals also should provide a copy of the Notice of Election to the examining agent or Appeals Officer.

The Notice of Election must be signed under penalties of perjury. Further, the Corporation must disclose the identity (including taxpayer identification numbers) of all its current and former Executives that participated in the Transactions, and the Executive must disclose the Corporation's identity.

If the Corporation filed a consolidated federal income tax return for any taxable period affected by the terms of the settlement, then the parent of the affiliated group and each subsidiary that that participated in the Transaction must file a separate Notice of Election.

The Notice of Election requests information necessary to process the election and determine the proper tax liabilities. Additional information may be requested after the Notice of Election is submitted. The Service can decline to execute a closing agreement with any person that fails to provide requested information.

(b) Closing Agreement and Payment. After receiving all of the necessary information, the Service will prepare a closing agreement under § 7121 reflecting the terms of the settlement. The Service will send the closing agreement to the taxpayer, who must sign and return it to the Service within 30 days of the date of mailing by the Service. The Service may grant an extension for good cause.

Taxpayers must either submit payment in full of all taxes, interest, and penalties due under the terms of the settlement when they return the signed closing agreement to the Service, or make other financial arrangements as described below. If a person does not know the amount of the underpayment for the taxable year containing December 31, 2004, that person must make an estimated payment using the maximum applicable marginal rate. If the estimated payment exceeds the actual underpayment determined after the filing of that person's U.S. federal income tax return for the taxable year containing December 31, 2004, the person may request a refund for the excess. Any person not making full payment must submit complete financial statements and agree to other financial arrangements acceptable to the Service before the Service will execute a closing agreement. The Service will not execute a closing agreement with anyone unable to reach acceptable financial arrangements.

Directors, Field Operations (Large & Mid-Size Business) are authorized to execute closing agreements prepared under this settlement initiative, including agreements for taxable periods ending after the date on which the agreement is executed, on behalf of the Service. This authority may not be redelegated.

Section 5. Non-Participants' Dispute Resolution Procedures

(a) Case Development. The Service has examined numerous Transactions, which, except for minor factual variations, follow a common template. The Service has determined that notwithstanding the factual differences, these Transactions should be treated similarly for purposes of this settlement initiative and do not warrant terms more favorable than this settlement initiative. The Service will develop all of the potential

issues, make appropriate income and expense adjustments for all tax benefits and attributes claimed, and determine appropriate income and employment tax penalties for Executives, Related Persons, and Corporations that do not participate in this settlement initiative (non-participants).

(b) Appeals Consideration. Non-participants may request Appeals review of disputed tax and penalty determinations. Appeals has independently considered the issues raised by these Transactions with respect to Executives (and the Related Persons), and has evaluated the potential litigation hazards. Appeals has concluded that Executives and Related Persons should not expect a resolution of either the tax or penalty issues on terms that are more favorable than the terms offered in this settlement initiative. In addition, the resolution of a taxpayer's case in Appeals will be based on the merits of the issues presented and will not involve administrative terms, such as the deferral of the recognition of income by the Executive. Consequently, a resolution of a Transaction with Appeals may be less favorable than the terms of this settlement initiative.

Appeals has not reviewed the corporate income tax, employment tax or penalty issues raised by these Transactions with respect to any Corporation. These include: (1) withholding for supplemental wages, (2) employer's and employee's FICA taxes, (3) failure to deposit penalties, (4) accuracy-related penalties on failure to pay income tax withholding or FICA tax, (5) disallowance of deduction for Transaction Costs paid on behalf of the Executive and associated accuracy-related penalties, (6) information reporting penalty for furnishing incorrect W-2s, and (7) disallowance of deduction for stock option compensation income. Independent Appeals' consideration will be available for Corporations not taking part in this settlement initiative with respect to disputed tax and penalty issues following full development of these issues by the Service.

Section 6. Paperwork Reduction Act

The collection of information in this announcement has been reviewed and approved by the Office of Management and Budget under the Paperwork Reduction Act (44 U.S.C. § 3507) under control number 1545-1929. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless collecting information displays a valid OMB number.

The collection of information in this announcement is in Section 4, Procedures for Closing Cases. This information is required to apply the terms of the settlement and determine the suitable amount of any penalties. Collecting information is required to obtain the benefit described in this announcement. The likely respondents are individuals and businesses or other for-profit institutions.

The estimated total annual reporting burden is 875 hours.

The estimated annual burden per respondent varies from 3 to 7 hours, depending on individual circumstances, with an estimated average of 5 hours. The estimated number of respondents is 175.

The estimated frequency of responses is one time per respondent.

Books or records about a collection of information must be retained as long as their content may become material in administering any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C § 6103.

Section 7. Contact Information

The principal authors of this announcement are Stephen Tackney of the Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities) and Rebecca E. Asta of the Office of Chief Counsel. However, other personnel from the Treasury Department and the Service participated in its development. For information about this announcement, contact Dean O'Brien at (972) 308-1233 (not a toll free number) or by email at dean.a.o'brien@irs.gov.